

**SOUTHWEST CATHOLIC  
HEALTH NETWORK CORPORATION  
dba MERCY CARE PLAN**

**FINANCIAL STATEMENTS**

Years Ended June 30, 2008 and 2007



**Mayer Hoffman McCann P.C.**

**An Independent CPA Firm**

3101 North Central Avenue, Suite 300

Phoenix, Arizona 85012

602-264-6835 ph

602-265-7631 fx

www.mhm-pc.com

## **INDEPENDENT AUDITORS' REPORT**

The Board of Directors

### **SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION dba MERCY CARE PLAN**

We have audited the accompanying statement of financial position of **Southwest Catholic Health Network Corporation (SCHN) dba Mercy Care Plan** as of June 30, 2008, and the related statements of activities and changes in net assets, and cash flows for the year then ended. These financial statements are the responsibility of SCHN's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of SCHN as of June 30, 2007, and for the year then ended, were audited by other auditors whose report dated November 12, 2007, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with U.S. generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 2008 financial statements referred to above present fairly, in all material respects, the financial position of **Southwest Catholic Health Network Corporation dba Mercy Care Plan** at June 30, 2008, and the results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

*Mayer Hoffman McCann P.C.*

Phoenix, Arizona  
October 27, 2008

**SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION**  
**dba MERCY CARE PLAN**

**STATEMENTS OF FINANCIAL POSITION**

June 30, 2008 and 2007  
(In thousands)

	<u><b>ASSETS</b></u>	
	<u><b>2008</b></u>	<u><b>2007</b></u>
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 15,668	\$ 118,790
Short-term investments	35,894	45,018
Receivables:		
Reinsurance receivables, net of allowance for doubtful accounts of \$3,128 for 2008 and \$1,836 for 2007	92,069	45,499
Reconciliation receivables, net of allowance for doubtful accounts of \$3,303 for 2008 and \$7,121 for 2007	71,372	53,739
Capitation and supplement receivables	7,479	5,438
Pharmacy receivable	5,220	2,089
Third party liability receivable	2,685	2,056
Interest receivable	883	931
Provider advances, net of allowance for doubtful accounts of \$1,474 for 2008 and \$1,472 for 2007	26,593	15,382
Other current assets	<u>5,990</u>	<u>656</u>
<b>TOTAL CURRENT ASSETS</b>	<b>263,853</b>	<b>289,598</b>
<b>LONG-TERM INVESTMENTS</b>	<b>132,435</b>	<b>121,515</b>
<b>PENSION ASSET</b>	<u><b>629</b></u>	<u><b>261</b></u>
<b>TOTAL ASSETS</b>	<u><b>\$ 396,917</b></u>	<u><b>\$ 411,374</b></u>
 <u><b>LIABILITIES AND NET ASSETS</b></u>		
<b>CURRENT LIABILITIES</b>		
Medical claims payable	\$ 271,932	\$ 239,390
Deferred revenue	-	19,099
Due to Aetna	2,164	269
Other current liabilities	3,972	4,871
Current portion of risk share settlement	<u>1,366</u>	<u>16,477</u>
<b>TOTAL CURRENT LIABILITIES</b>	<b>279,434</b>	<b>280,106</b>
<b>RISK SHARE SETTLEMENT, less current maturities</b>	<b>-</b>	<b>1,390</b>
<b>UNRESTRICTED NET ASSETS</b>	<u><b>117,483</b></u>	<u><b>129,878</b></u>
<b>TOTAL LIABILITIES AND NET ASSETS</b>	<u><b>\$ 396,917</b></u>	<u><b>\$ 411,374</b></u>

See Notes to Financial Statements

**SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION**  
**dba MERCY CARE PLAN**

**STATEMENTS OF ACTIVITIES AND CHANGES IN NET ASSETS**

Year Ended June 30, 2008 and 2007  
(In thousands)

	<u>2008</u>	<u>2007</u>
<b>OPERATING REVENUES</b>		
Capitation premiums	\$ 1,568,131	\$ 1,405,169
Delivery/hospital/HIV-AIDS supplement	97,161	90,288
Reinsurance	131,694	123,620
Other, primarily third-party recoveries	<u>6,526</u>	<u>3,674</u>
<b>TOTAL OPERATING REVENUES</b>	<u>1,803,512</u>	<u>1,622,751</u>
<b>HEALTH CARE EXPENSES</b>		
Hospitalization	512,410	448,599
Medical compensation	264,452	225,554
Ancillary and other medical services	605,032	536,358
Institutional	133,187	138,144
Home and community based services	<u>109,092</u>	<u>89,611</u>
<b>TOTAL HEALTH CARE EXPENSES</b>	<u>1,624,173</u>	<u>1,438,266</u>
<b>GENERAL AND ADMINISTRATIVE EXPENSES</b>	132,101	119,309
<b>PREMIUM TAX EXPENSE</b>	<u>28,613</u>	<u>26,081</u>
<b>TOTAL EXPENSES</b>	<u>1,784,887</u>	<u>1,583,656</u>
<b>OPERATING INCOME</b>	<u>18,625</u>	<u>39,095</u>
<b>NONOPERATING INCOME (EXPENSE)</b>		
Investment income	14,127	16,566
Other	<u>(650)</u>	<u>(726)</u>
<b>TOTAL NONOPERATING INCOME (EXPENSE)</b>	<u>13,477</u>	<u>15,840</u>
<b>EXCESS OF REVENUE OVER EXPENSES</b>	32,102	54,935
<b>MINIMUM PENSION LIABILITY</b>	-	(67)
<b>UNREALIZED GAINS (LOSSES) ON INVESTMENTS</b>	(6,497)	5,359
<b>DISTRIBUTION TO SPONSOR ORGANIZATIONS</b>	<u>(38,000)</u>	<u>-</u>
<b>CHANGE IN NET ASSETS</b>	(12,395)	60,227
<b>NET ASSETS, BEGINNING OF YEAR</b>	<u>129,878</u>	<u>69,651</u>
<b>NET ASSETS, END OF YEAR</b>	<u>\$ 117,483</u>	<u>\$ 129,878</u>

See Notes to Financial Statements

**SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION**  
**dba MERCY CARE PLAN**

**STATEMENTS OF CASH FLOWS**

Year Ended June 30, 2008 and 2007  
(In thousands)

	<u>2008</u>	<u>2007</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Change in net assets	\$ (12,395)	\$ 60,227
Equity distributions to sponsor organizations	38,000	-
Adjustments to reconcile change in net assets to net cash provided by (used in) operating activities:		
Pension asset	(368)	(232)
Bad debt expense	(1,717)	3,545
Net unrealized (gains) losses on investments	6,497	(5,359)
Net realized gains on investments	(3,052)	(4,784)
Change in operating assets and liabilities:		
Decrease (increase) in:		
Reinsurance receivables	(47,862)	(4,934)
Reconciliation receivables	(14,482)	(36,771)
Capitation and supplement receivables	(2,183)	(939)
Pharmacy receivable	(3,131)	1,022
Third party liability receivable	(629)	(421)
Interest receivable	48	(245)
Provider advances	(11,211)	1,026
Other current assets	(5,334)	(74)
Increase (decrease) in:		
Medical claims payable	32,542	24,571
Due to Aetna	1,895	973
Deferred revenue	(19,099)	(851)
Risk share settlement	(16,501)	9,398
Other current liabilities	(899)	(528)
Net cash provided by (used in) operating activities	<u>(59,881)</u>	<u>45,624</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchases of investments	(187,219)	(137,621)
Proceeds from sale of investments	181,978	118,489
Net cash provided by (used in) investing activities	<u>(5,241)</u>	<u>(19,132)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Distribution to sponsor organizations	(38,000)	-
Net cash used in financing activities	(38,000)	-
<b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>	(103,122)	26,492
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR</b>	<u>118,790</u>	<u>92,298</u>
<b>CASH AND CASH EQUIVALENTS, END OF YEAR</b>	<u>\$ 15,668</u>	<u>\$ 118,790</u>

See Notes to Financial Statements

**SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION  
dba MERCY CARE PLAN**

**NOTES TO FINANCIAL STATEMENTS**

Years Ended June 30, 2008 and 2007

**(1) Company operations and significant accounting policies**

**Company operations** - Southwest Catholic Health Network Corporation dba Mercy Care Plan (SCHN, or the Plan) is a nonprofit corporation, whose sponsor organizations are Catholic Healthcare West Arizona (CHW Arizona) and Carondelet Health Care Corporation of Arizona (Carondelet), collectively the "sponsors." SCHN provides medical care under contract with the Arizona Health Care Cost Containment System (AHCCCS), a department of the state of Arizona charged with administering health care for the state's indigent population. SCHN is also under contract with the AHCCCS Healthcare Group (HCG) to provide coverage primarily to small businesses, and the Arizona Long Term Care System (ALTCS) to provide institutional care, home and community based services and behavioral health services to the long term care members. SCHN also provides medical care to qualified members through a contract with the Arizona Department of Economic Security Division of Developmental Disabilities (DES/DDD).

SCHN operates a Medicare Advantage Plan (Medicare Advantage) with the Centers for Medicare and Medicaid Services (CMS), offering medical and prescription drug benefits to qualified members. Medicare Advantage operates as a special needs plan under CMS guidelines. The populations covered under Medicare Advantage are members who are eligible for both Medicare and Medicaid coverage. Virtually all of the members of Medicare Advantage receive their Medicaid benefits through one of SCHN's AHCCCS contracts.

SCHN has entered into a management agreement with Aetna through June 30, 2010. Under the terms of the agreement, SCHN pays a monthly fee to Aetna, as defined in the agreement, to cover the employee salary and benefit costs and general and administrative expenses incurred to operate the Plan. SCHN paid management fees per the agreement of approximately \$123,544,000 and \$111,510,000 for the years ended June 30, 2008 and 2007, respectively.

A summary of the Plan's significant accounting policies follows:

**Basis of presentation** - The accompanying financial statements have been prepared in accordance with the *Health Care Organization's Audit and Accounting Guide* issued by the American Institute of Certified Public Accountants. SCHN's financial statements are also presented in accordance with Statement of Financial Accounting Standards (SFAS) No. 117, *Financial Statements of Not-For-Profit Organizations*. Under SFAS No. 117, SCHN is required to report information regarding its financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets and permanently restricted net assets. Temporarily restricted net assets are those whose use by SCHN has been limited by donors to a specific time period or purpose.

**Capitation premiums** - The Plan receives from AHCCCS fixed capitation payments, generally in advance, based on certain rates for each AHCCCS member enrolled with the Plan. The Plan is required to provide all covered health care services to their members, regardless of the cost of care. If there are funds remaining, the Plan retains the funds as profit; if the costs are higher than the amount of capitation payments from AHCCCS, the Plan absorbs the loss. Capitation premiums are recognized in the month that enrollees are entitled to health care services. Certain provisions of the AHCCCS Acute, HCG, and ALTCS contracts include a risk band whereby SCHN and the AHCCCS programs share in the profits and losses of the contract, as defined in the respective contracts (reconciliation revenue). SCHN has recorded an estimate of the reconciliation revenue, within capitation premiums, based on the operational performance of the AHCCCS Acute, HCG and ALTCS lines of business. The Plan may recover certain losses for those cases eligible for reinsurance payments.

# SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION

## dba MERCY CARE PLAN

### NOTES TO FINANCIAL STATEMENTS

Years Ended June 30, 2008 and 2007

**(1) Company operations and significant accounting policies (continued)**

Capitation is paid prospectively as well as for prior period coverage (PPC). The PPC period is from the first day of the month of application to the time of enrollment with a contracted health plan. The risk under PPC is shared by both the Plan and AHCCCS for the contract year ended September 30, 2008. AHCCCS reconciles the actual PPC medical costs to the PPC capitation paid during the contract year. The reconciliation limits the contractor's profits and losses to 2%. At June 30, 2008 and 2007, reconciliation receivables include approximately \$42,733,000 and \$31,386,000, respectively of estimated settlement payments due from AHCCCS for the PPC reconciliation for contract years 2006, 2007, and 2008.

Reconciliation receivables are stated at the amount management expects to collect. Management provides for probable uncollectible amounts through a charge to earnings and a credit to a valuation allowance based on its assessment of the current status of individual balances. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to reconciliation claims receivable. At June 30, 2008 and 2007, reconciliation receivables were net of an allowance for doubtful accounts of approximately \$3,303,000 and \$7,121,000, respectively.

**Delivery revenue** - Delivery supplemental revenue is reimbursement from AHCCCS intended to cover the cost of maternity care. Such premiums are recognized in the month that the delivery occurs.

**Hospital revenue** - Hospital supplemental revenue is reimbursement from AHCCCS for certain members who are in an inpatient setting on the date of application for AHCCCS eligibility. This additional one-time reimbursement is intended to help the Plan defray medical costs associated with inpatient stays. Such premiums are recognized in the month that SCHN is informed of the patients' eligibility and services are rendered.

**HIV-AIDS supplemental revenue** - HIV-AIDS supplemental revenue is reimbursement from AHCCCS intended to help defray the costs of HIV/AIDS drugs. Such premiums are recognized in the month that services are rendered.

**Reinsurance revenue** - AHCCCS provides a stop-loss reinsurance program for the Plan for partial reimbursement of reinsurable covered medical services incurred for members. The program includes a deductible, which varies based on the Plan's enrollment and the eligibility category of the members. AHCCCS reimburses the Plan based on a coinsurance amount for reinsurable covered services incurred above the deductible. Reinsurance revenue is stated at the actual and estimated amounts due to SCHN pursuant to the AHCCCS Acute, DES/DDD, HCG, ALTCS and Medicare Advantage Plan contracts. Below are the reinsurance thresholds by line of business:

<u>Line of Business</u>	<u>Annual Deductible</u>	<u>Coinsurance</u>
AHCCCS Acute – Prospective Only	\$20,000	75%
Title XIX Waiver Group – Prospective Only	15,000	75
DES/DDD	20,000	75
DES/DDD Ventilator Dependent	No deductible	100
HCG	115,000	90
ALTCS w/Medicare	20,000	75
ALTCS w/o Medicare	30,000	75
Medicare Advantage	300,000	90

**SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION**  
**dba MERCY CARE PLAN**

**NOTES TO FINANCIAL STATEMENTS**

Years Ended June 30, 2008 and 2007

**(1) Company operations and significant accounting policies (continued)**

To be eligible for reinsurance billing, qualified healthcare expenses must be incurred during the contract year. Reinsurance revenue is recorded based on actual billed reinsurance claims adjusted for medical cost completion factors and SCHN's historical collection experience. Reinsurance revenue is subject to review by AHCCCS, and as a result, there is at least a reasonable possibility that recorded reinsurance revenue will change by a material amount in the near future.

Reinsurance claims receivable result from additional payments from the AHCCCS Administration to the Plan for certain enrollees whose qualifying medical expenses paid by the Plan were in excess of specified deductible limits. Reinsurance claims receivables are stated at the amount management expects to collect. Management provides for probable uncollectible amounts through a charge to earnings and a credit to a valuation allowance based on its assessment of the current status of individual balances. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to reinsurance claims receivable. At June 30, 2008 and 2007, reinsurance receivable was net of an allowance for doubtful accounts of approximately \$3,128,000 and \$1,836,000, respectively.

**Cash and cash equivalents** - Cash includes cash deposits in banks and cash equivalents. SCHN considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. Amounts at each institution are insured in limited amounts by the Federal Deposit Insurance Corporation (FDIC).

**Pharmacy receivable** - SCHN receives rebates from pharmaceutical companies based on the volume of drugs purchased. SCHN records a receivable and a reduction of medical expenses for estimated rebates due based on purchase information. At June 30, 2008 and 2007, management believes these balances are fully collectible and accordingly, an allowance has not been established.

**Third party liability receivable** - In cases such as motor vehicle accidents and worker's compensation claims, a third party insurer may be liable for a claim. When SCHN pays claims on behalf of its members and determines a third party insurance company is ultimately responsible for that claim, it records a receivable and recoups the claim cost from the third party insurer. At June 30, 2008 and 2007, management believes these balances are fully collectible and accordingly, an allowance has not been established.

**Provider advances** - Upon request, SCHN may advance monies to high-volume providers based on cash flow needs and timing of claims payments. Advances are stated at the amount management expects to collect or offset against future claims. Management provides for probable uncollectible amounts through a charge to earnings and a credit to a valuation allowance based on its assessment of the current status of individual balances. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to provider advances receivable. At June 30, 2008 and 2007, provider advance receivables were net of an allowance for doubtful accounts of approximately \$1,474,000 and \$1,472,000, respectively.

**Other current assets** - Other current assets consist of prepaid expenses and other interest receivable. In April 2008, approximately \$4,381,000 in interest was overpaid to providers. These monies were either recouped in July 2008 through deductions of claims payments or through reimbursement by the providers. At June 30, 2008, management believes the other interest receivable is fully collectible and accordingly, an allowance has not been established.



**SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION**  
**dba MERCY CARE PLAN**

**NOTES TO FINANCIAL STATEMENTS**

Years Ended June 30, 2008 and 2007

**(1) Company operations and significant accounting policies (continued)**

**Investments** - Investments are recorded in accordance with SFAS No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*. Investments in equity and debt securities that have readily determinable fair values are recorded at quoted market prices. SCHN's investment portfolio is managed by professional investment managers within guidelines established by SCHN's Board of Directors which, as a matter of policy, limits the amounts which may be invested in any one issuer or type of investment.

**Investment income** - Investment income consists primarily of interest and dividends. Interest is recognized on the accrual basis, and dividends are recorded as earned on the ex-dividend date. Interest income on mortgage- and asset-backed securities is determined on the effective yield method based on estimated principal repayments. Accrual of income is suspended for bonds and mortgage loans that are in default or when the receipt of interest payments is in doubt. SCHN has a policy to review and identify investments with declines in value that would be considered to be other-than-temporary. Such other-than-temporary declines, if significant, are accounted for as realized losses (See Note 2).

**Deferred revenue** - Medicare Advantage capitation premiums received in the month prior to enrollee coverage are deferred and recognized in revenue in the succeeding month.

**Risk share settlement** - The risk share settlement represents expected payments to be paid to CMS in connection with the pharmacy component of Medicare Advantage. This balance is reviewed and monitored by management and adjusted as necessary as experience develops or new information becomes available. Such adjustments are netted against the capitation premiums on the statements of activities and changes in net assets. The pharmacy risk share settlement, recorded at June 30, 2008, is expected to be finalized as follows in late 2008.

**Premium deficiency reserve** - As of June 30, 2007, SCHN recorded a premium deficiency reserve of \$5,800,000 as a result of continuing operating losses sustained, incurred from one component of the AHCCCS contract, for which the annual premium was not sufficient to cover the operating losses. The reserve was adequate to cover future losses through the end of the contract year ending September 30, 2007, the end of the contract year. The premium deficiency reserve is recorded within claims liability on the statements of financial position as of June 30, 2007.

As of June 30, 2008, SCHN recorded a premium deficiency reserve of \$8,898,000 as a result of losses in its Medicare contract to cover losses through the end of the contract year ending December 31, 2008. The premium deficiency reserve is recorded within claims liability on the statements of financial position as of June 30, 2008.

**Healthcare service cost recognition** - The costs of providing hospitalization, medical compensation, ancillary and other medical services, institutional, and home and community based services are accrued in the period in which the service is provided to eligible recipients based in part on estimates, including an accrual for services incurred but to yet reported to SCHN.

The estimate for unreported services payable is developed using actuarial methods based on historical experience and are continually reviewed by management and adjusted as necessary based on current claims data, and medical cost completion factors. Such adjustments are included in health care expenses in the statements of activities and changes in net assets. While management believes the amount is adequate, the ultimate liability may be in excess of or less than the amount provided. There is at least a reasonable possibility that the recorded estimates will change by a material amount, in the near future.

# SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION dba MERCY CARE PLAN

## NOTES TO FINANCIAL STATEMENTS

Years Ended June 30, 2008 and 2007

**(1) Company operations and significant accounting policies (continued)**

**Management's use of estimates** - The preparation of the financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates include the allowances for doubtful accounts, the estimate for medical claims payable, and the estimate for the premiums deficiency reserve.

**Income taxes** - Southwest Catholic Health Network Corporation dba Mercy Care Plan qualifies as a tax exempt organization under Section 501(c)(3) of the Internal Revenue Code (the "Code") and, therefore, there is no provision for income taxes. Income determined to be unrelated business taxable income (UBTI) would be taxable.

**(2) Investments**

The cost and fair value of SCHN's investments by type at June 30 are as follows (in thousands):

	2008		2007	
	Cost	Fair Value	Cost	Fair Value
Short-term:				
Mutual funds	\$ 24,651	\$ 24,651	\$ 25,766	\$ 25,766
Corporate bonds	5,840	5,891	7,808	7,824
U.S. Government securities	5,293	5,352	11,354	11,428
	<u>35,784</u>	<u>35,894</u>	<u>44,928</u>	<u>45,018</u>
Long-term:				
Marketable equity securities	52,673	55,340	47,650	57,193
U.S. Government securities	41,740	41,628	27,715	27,383
Corporate bonds	15,886	16,044	13,176	13,092
Mortgage-backed securities	16,424	16,473	20,888	20,439
Preferred securities	3,310	2,950	3,492	3,408
	<u>130,033</u>	<u>132,435</u>	<u>112,921</u>	<u>121,515</u>
	<u>\$ 165,817</u>	<u>\$ 168,329</u>	<u>\$ 157,849</u>	<u>\$ 166,533</u>

Investment income for the years ended June 30 is comprised of the following (in thousands):

	2008	2007
Revenue (included in nonoperating investment income):		
Interest income	\$ 11,075	\$ 11,782
Realized gains on sales of investments	3,052	4,784
	<u>\$ 14,127</u>	<u>\$ 16,566</u>

Management continually reviews its investment portfolio and evaluates whether declines in the fair value of securities should be considered other-than-temporary. Factored into this evaluation are the general market conditions, the issuer's financial condition and near-term prospects, conditions in the issuer's industry, the recommendation of advisors and the length of time and extent to which the market value has been less than cost. During the years ended June 30, 2008 and 2007, SCHN did not record a realized loss for other-than-temporary declines in the fair value of investments.

**SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION**  
**dba MERCY CARE PLAN**

**NOTES TO FINANCIAL STATEMENTS**

Years Ended June 30, 2008 and 2007

**(2) Investments (continued)**

The following table summarizes the unrealized losses on investments held at June 30, 2008 (in thousands):

Description of securities	Less than twelve months		Twelve months or longer		Total	
	Unrealized		Unrealized		Unrealized	
	Fair value	losses	Fair value	losses	Fair value	losses
U.S. Government securities	\$ 30,689	\$ 602	\$ 604	\$ 42	\$ 31,293	\$ 644
Marketable equity securities	20,606	3,080	1,645	1,244	22,251	4,324
Corporate bonds	12,178	268	1,482	39	13,660	307
Mortgage-backed securities	6,281	47	551	10	6,832	57
Preferred securities	997	1	1,954	358	2,951	359
Total	<u>\$ 70,751</u>	<u>\$ 3,998</u>	<u>\$ 6,236</u>	<u>\$ 1,693</u>	<u>\$ 76,987</u>	<u>\$ 5,691</u>

The following table summarizes the unrealized losses on investments held at June 30, 2007 (in thousands):

Description of securities	Less than twelve months		Twelve months or longer		Total	
	Unrealized		Unrealized		Unrealized	
	Fair value	losses	Fair value	losses	Fair value	losses
U.S. Government securities	\$ 13,265	\$ 192	\$ 7,534	\$ 242	\$ 20,799	\$ 434
Marketable equity securities	10,903	572	1,097	54	12,000	626
Corporate bonds	3,880	48	5,392	156	9,272	204
Mortgage-backed securities	9,027	266	8,869	215	17,896	481
Preferred securities	1,584	53	1,250	39	2,834	92
Total	<u>\$ 38,659</u>	<u>\$ 1,131</u>	<u>\$ 24,142</u>	<u>\$ 706</u>	<u>\$ 62,801</u>	<u>\$ 1,837</u>

Long-term investments can be liquidated without significant penalty within twenty-four hours, and are considered short-term for purposes of calculating current ratios under AHCCCS reporting guidelines.

**(3) Related party transactions**

SCHN paid approximately \$119,720,000 in 2008 and \$95,091,000 in 2007 to CHW Arizona and approximately \$38,287,000 in 2008 and \$31,248,000 in 2007 to Carondelet for hospitalization and other medical services provided to its members. These balances include net prospective provider advance payments made to CHW Arizona and Carondelet. In September 2007, SCHN made net asset distributions of \$19,000,000 each to CHW Arizona and Carondelet. This distribution was approved by AHCCCS. In August 2008, SCHN's finance committee, on behalf of the board of directors, approved a net asset distribution of \$9,500,000 each to CHW Arizona and Carondelet. A request for approval of the distribution was approved by AHCCCS on September 16, 2008.

# SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION

## dba MERCY CARE PLAN

### NOTES TO FINANCIAL STATEMENTS

Years Ended June 30, 2008 and 2007

**(4) Leases**

SCHN had an agreement to lease certain office space in Phoenix. During the term of the Aetna agreement, Aetna is responsible for reimbursing SCHN for the lease payments. The lease agreement contains scheduled rent escalations, and the lease has an option to renew the lease for five years. SCHN allowed the lease to expire in January 2008.

Rent expense was approximately \$1,578,000 in from July 2007 through January 2008. Aetna became directly responsible for future lease payments as of January 2008 as part of its management agreement.

**(5) Retirement benefits**

SCHN has a noncontributory defined benefit pension plan (Pension Plan) covering all eligible employees. All employees were covered on the first day of the month coincident with the completion of one year of service. Pension Plan benefits were based on the employee's career compensation.

Effective May 31, 2002, the Pension Plan was frozen based on salaries earned through April 30, 2002. SCHN will continue to make annual contributions to the defined benefit pension plan in amounts sufficient to meet the minimum funding requirements of the Employment Retirement Income Security Act (ERISA). In July 2006, the Board of Directors of SCHN voted to terminate the Pension Plan. The Pension Plan will be fully funded, and vested amounts distributed, during fiscal year 2009.

On June 30, 2007, SCHN adopted the recognition and disclosure provisions of FAS 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R) (FAS 158). FAS 158 required SCHN to recognize the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligation) of its defined pension plan in the June 30, 2007 statement of financial position. The adoption of FAS 158 did not have any affect on the recognition of the funded status of the Pension Plan.

SCHN uses a measurement date of July 1 for the Pension Plan. The amount due Pension Plan participants at termination will likely differ from the projected benefit obligation reflected in the table below. The following table sets forth the Pension Plan funded status as provided by independent actuaries at July 1:

	<u>2008</u>	<u>2007</u>
	<i>(In thousands)</i>	
Projected benefit obligation	\$ 3,591	\$ 3,667
Fair value of plan assets	<u>4,220</u>	<u>3,928</u>
Funded status of the plan	629	261
Unrecognized net actuarial loss	1,022	1,010
Components of net periodic benefit cost:		
Interest cost	235	228
Expected return on plan assets	(349)	(326)
Recognized net actuarial loss	<u>19</u>	<u>19</u>
Total net periodic pension cost	(95)	(79)
Employer contributions	300	300
Benefits paid	139	111

# SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION dba MERCY CARE PLAN

## NOTES TO FINANCIAL STATEMENTS

Years Ended June 30, 2008 and 2007

**(5) Retirement benefits (continued)**

Weighted-average assumptions used to determine net periodic pension cost were as follows as of June 30:

	<u>2008</u>	<u>2007</u>
Discount rate	6.60%	6.25%
Expected return on plan assets	8.00%	8.00%

Due to the planned termination of the Pension Plan, SCHN has liquidated the Pension Plan's investment assets. Accordingly, all assets are held in cash and cash equivalents at June 30, 2008. SCHN anticipates making adequate contributions to the Pension Plan to ensure that the Pension Plan's assets meet the expected termination liability.

**(6) Commitments and contingencies**

**Letters of credit** - At June 30, 2008 and 2007, SCHN has irrevocable standby letters of credit to satisfy the AHCCCS Acute, DES/DDD and ALTCS general performance bond requirements. Total amounts available are \$61,650,000 at June 30, 2008. No draws have been made on the letters of credit as of June 30, 2008. The letters of credit are collateralized by investments of SCHN. To meet Medicare requirements, SCHN has entered into demand note agreements dated January 1, 2006 with CHW Arizona and Carondelet which allows SCHN to draw, upon demand, up to a combined maximum amount of \$10,000,000. There were no draws on the note agreements as of June 30, 2008 and June 30, 2007.

**Contract compliance** - Under the terms of the AHCCCS contract, SCHN is required to meet certain financial covenants. As of June 30, 2008, SCHN is in compliance with the AHCCCS covenants with the exception of the current ratio under the HCG contract. SCHN obtained a waiver for a current ratio noncompliance from HCG. Mercy Care Advantage (MCA) is out of compliance with current ratio and equity requirements. SCHN received approval on September 16, 2008 from AHCCCS to transfer equity from ALTCS to MCA to meet current ratio and equity requirements.

**Litigation** - Periodically, SCHN is involved in litigation and claims arising in the normal course of operations. In the opinion of management based on consultation with legal counsel, losses, if any, from these matters are covered by insurance or are immaterial.

SCHN is involved in grievances associated with its operations. Included in these matters is a grievance filed by various hospitals challenging payments they are receiving from the State of Arizona and health plans under the AHCCCS reimbursement system, which was implemented on March 1, 1993. The hospitals seek retrospective and prospective relief. SCHN has denied liability in this matter on the basis that the rates are imposed by AHCCCS. Management believes that any resulting liability, if any, will not materially affect SCHN's financial position.

**Healthcare regulation** - The healthcare industry is subject to numerous laws and regulations of federal, state and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Violations of these laws and regulations could result in expulsion from government healthcare programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Management believes that SCHN is in compliance with fraud and abuse laws and regulations, as well as other applicable government laws and regulations. Compliance with such laws and regulations can be subject to future reviews and interpretation as well as regulatory actions unknown or unasserted at this time.

**SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION**  
**dba MERCY CARE PLAN**

**NOTES TO FINANCIAL STATEMENTS**

Years Ended June 30, 2008 and 2007

**(7) Concentration of credit risk**

Future contract awards are contingent upon the continuation of the AHCCCS Acute, DES/DDD, HCG, and ALTCS programs by the State of Arizona and SCHN's ability and desire to retain its status as a contractor under these programs. The AHCCCS Acute contract expired on September 30, 2008. Through a bid process, SCHN was awarded a contract effective October 1, 2008 through September 30, 2011, with two additional one year renewal options. The ALTCS contract expires on September 30, 2009, with two one-year renewal options. The DES/DDD contract expired on September 30, 2008 with annual renewal options. The DES/DDD contract was renewed on October 1, 2008 for one year. The HCG contract expired June 30, 2008. The contract was extended until October 31, 2008 and is expected to be renewed after that date. The Medicare Advantage contract is renewed annually by CMS.

**(8) Recent accounting pronouncements**

In September 2006, the FASB issued Statement of Financial Accounting Standards, No. 157, Fair Value Measurements (SFAS 157), which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS 157, among other things, eliminates the inconsistencies in defining fair value and applying those definitions and provides for more comparability in fair value measurements. Under SFAS 157, the fair value definition focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price) from the perspective of a "market participant," not the price that would be paid to acquire the asset or received to assume the liability (an entry price). SFAS 157 is effective for financial statements issued for years beginning after November 15, 2007, which would be fiscal year 2009 for SCHN. SFAS 157 is not expected to have a significant impact on SCHN's financial statements.

**SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION**  
**dba MERCY CARE PLAN**

**SUPPLEMENTAL STATEMENT OF FINANCIAL POSITION**

June 30, 2008  
(In thousands)

**ASSETS**

	<b>AHCCCS</b>	<b>DES/DDD</b>	<b>HCG</b>	<b>ALTCS</b>	<b>Medicare</b>	<b>Total</b>
<b>CURRENT ASSETS</b>						
Cash and cash equivalents	\$ 15,668	\$ -	\$ -	\$ -	\$ -	\$ 15,668
Short-term investments	20,105	1,937	802	11,067	1,983	35,894
Receivables:						
Reinsurance receivables, net	64,375	2,372	-	25,280	42	92,069
Reconciliation receivables, net	58,906	-	13,219	(753)	-	71,372
Capitation and supplement receivables	5,304	(70)	-	92	2,153	7,479
Pharmacy receivable	3,095	193	124	216	1,592	5,220
Third party liability receivable	2,464	-	221	-	-	2,685
Interest receivable	494	48	20	272	49	883
Provider advances, net	18,376	459	312	3,175	4,271	26,593
Intercompany	(61,168)	(2,638)	(15,028)	58,451	20,383	-
Other current assets	5,767	-	-	-	223	5,990
<b>TOTAL CURRENT ASSETS</b>	<b>133,386</b>	<b>2,301</b>	<b>(330)</b>	<b>97,800</b>	<b>30,696</b>	<b>263,853</b>
<b>LONG-TERM INVESTMENTS</b>	<b>74,181</b>	<b>7,146</b>	<b>2,960</b>	<b>40,832</b>	<b>7,316</b>	<b>132,435</b>
<b>PENSION ASSET</b>	<b>629</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>629</b>
<b>TOTAL ASSETS</b>	<b><u>\$208,196</u></b>	<b><u>\$ 9,447</u></b>	<b><u>\$ 2,630</u></b>	<b><u>\$138,632</u></b>	<b><u>\$ 38,012</u></b>	<b><u>\$ 396,917</u></b>

**LIABILITIES AND NET ASSETS (DEFICIT)**

<b>CURRENT LIABILITIES</b>						
Medical claims payable	\$167,094	\$ 4,284	\$ 4,239	\$ 48,228	\$ 48,087	\$ 271,932
Deferred revenue	-	-	-	-	-	-
Due to Aetna	1,887	-	-	-	277	2,164
Other current liabilities	381	10	-	2,341	1,240	3,972
Current portion of risk share settlement	-	-	-	-	1,366	1,366
<b>TOTAL CURRENT LIABILITIES</b>	<b>169,362</b>	<b>4,294</b>	<b>4,239</b>	<b>50,569</b>	<b>50,970</b>	<b>279,434</b>
<b>UNRESTRICTED NET ASSETS (DEFICIT)</b>	<b><u>38,834</u></b>	<b><u>5,153</u></b>	<b><u>(1,609)</u></b>	<b><u>88,063</u></b>	<b><u>(12,958)</u></b>	<b><u>117,483</u></b>
<b>TOTAL LIABILITIES AND NET ASSETS</b>	<b><u>\$208,196</u></b>	<b><u>\$ 9,447</u></b>	<b><u>\$ 2,630</u></b>	<b><u>\$138,632</u></b>	<b><u>\$ 38,012</u></b>	<b><u>\$ 396,917</u></b>

See Independent Auditors' Report on Additional Information

**SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION**  
**dba MERCY CARE PLAN**

**SUPPLEMENTAL STATEMENT OF ACTIVITIES AND CHANGES IN NET ASSETS**

Year Ended June 30, 2008  
(In thousands)

	<u>AHCCCS</u>	<u>DES/DDD</u>	<u>HCG</u>	<u>ALTCS</u>	<u>Medicare</u>	<u>Total</u>
<b>OPERATING REVENUES</b>						
Capitation premiums	\$ 945,036	\$ 30,843	\$ 28,474	\$ 321,227	\$ 242,551	\$ 1,568,131
Delivery/hospital/HIV-AIDS supplement	96,994	11	-	156	-	97,161
Reinsurance	92,738	3,305	192	34,470	989	131,694
Other, primarily third-party recoveries	5,691	16	241	386	192	6,526
<b>TOTAL OPERATING REVENUES</b>	<u>1,140,459</u>	<u>34,175</u>	<u>28,907</u>	<u>356,239</u>	<u>243,732</u>	<u>1,803,512</u>
<b>HEALTH CARE EXPENSES</b>						
Hospitalization	376,857	6,716	10,384	24,634	93,819	512,410
Medical compensation	204,867	2,504	2,477	6,002	48,602	264,452
Ancillary and other medical services	441,760	20,918	14,064	43,114	85,176	605,032
Institutional	-	-	-	118,879	14,308	133,187
Home and community based services	-	-	-	109,092	-	109,092
<b>TOTAL HEALTH CARE EXPENSES</b>	<u>1,023,484</u>	<u>30,138</u>	<u>26,925</u>	<u>301,721</u>	<u>241,905</u>	<u>1,624,173</u>
<b>GENERAL AND ADMINISTRATIVE EXPENSES</b>	83,370	2,263	3,304	21,080	22,084	132,101
<b>PREMIUM TAX EXPENSE</b>	<u>21,678</u>	<u>-</u>	<u>-</u>	<u>6,935</u>	<u>-</u>	<u>28,613</u>
<b>TOTAL EXPENSES</b>	<u>1,128,532</u>	<u>32,401</u>	<u>30,229</u>	<u>329,736</u>	<u>263,989</u>	<u>1,784,887</u>
<b>OPERATING INCOME (LOSS)</b>	<u>11,927</u>	<u>1,774</u>	<u>(1,322)</u>	<u>26,503</u>	<u>(20,257)</u>	<u>18,625</u>
<b>NONOPERATING INCOME (EXPENSE)</b>						
Investment income	8,242	722	299	4,125	739	14,127
Other	(650)	-	-	-	-	(650)
<b>TOTAL NONOPERATING INCOME (EXPENSE)</b>	<u>7,592</u>	<u>722</u>	<u>299</u>	<u>4,125</u>	<u>739</u>	<u>13,477</u>
<b>EXCESS (DEFICIENCY) OF REVENUE OVER EXPENSES</b>	19,519	2,496	(1,023)	30,628	(19,518)	32,102
<b>MINIMUM PENSION LIABILITY</b>	-	-	-	-	-	-
<b>UNREALIZED LOSSES ON INVESTMENTS</b>	(3,052)	(179)	(436)	(2,409)	(421)	(6,497)
<b>DISTRIBUTION TO SPONSOR ORGANIZATIONS</b>	<u>-</u>	<u>(5,000)</u>	<u>-</u>	<u>(23,000)</u>	<u>(10,000)</u>	<u>(38,000)</u>
<b>CHANGE IN NET ASSETS (DEFICIT)</b>	16,467	(2,683)	(1,459)	5,219	(29,939)	(12,395)
<b>NET ASSETS (DEFICIT), BEGINNING OF YEAR</b>	<u>22,367</u>	<u>7,836</u>	<u>(150)</u>	<u>82,844</u>	<u>16,981</u>	<u>129,878</u>
<b>NET ASSETS (DEFICIT), END OF YEAR</b>	<u>\$ 38,834</u>	<u>\$ 5,153</u>	<u>\$ (1,609)</u>	<u>\$ 88,063</u>	<u>\$ (12,958)</u>	<u>\$ 117,483</u>

See Independent Auditors' Report on Additional Information